

## SEC Releases Proposed Rule on Listing Standards for Compensation Committees

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*Enacted in 2010, Section 952 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Act) added Section 10C to the Securities Exchange Act of 1934 (the "Exchange Act"), which requires the SEC to adopt rules directing the national securities exchanges and national securities associations (together, the "Securities Exchanges") to prohibit the listing of any equity security of an issuer that is not in compliance with the requirements of Section 10C for compensation committees and compensation advisers.*

*To implement Section 952 of the Act, the SEC has proposed new Exchange Act Rule 10C-1 ("Proposed Rule 10C-1") for compensation committee listing standards and an amendment to Regulation S-K for disclosures of the use of compensation consultants ("S-K Amendment")*

*Due to the manner in which these rules are implemented, issuers will need to wait for further guidance from the Securities Exchange in which they trade to fully understand the impact of the rules. Proposed Rule 10C-1 serves as a set of guidelines to be used by the Securities Exchanges to develop their own rules. Each Securities Exchange would develop draft rules which the SEC would then review and approve, to ensure consistency with its guidelines, before they become final.*

### Background

Issues associated with executive compensation have been a primary concern of legislators and regulators since the credit crisis began. Many new executive compensation-related requirements were placed on companies that received TARP funds, and Congress has been debating the nature and extent of new legislation that should apply to companies broadly. The Act incorporated a number of new laws related to executive compensation, including provisions addressing disclosure, shareholder votes, compensation committee independence, clawback provisions in deferred compensation arrangements, and information on CEO pay relative to the company's workforce.

Section 10C of the Exchange Act requires the SEC to direct the Securities Exchanges to prohibit the listing of any equity security of an issuer (excluding five categories of exempt issuers) that does not comply with the rules regarding compensation committee independence and the use of compensation consultants. The SEC issued Proposed Rule 10C-1 and

the S-K Amendment to provide guidance on how to comply with these requirements.

Proposed Rule 10C-1 and the S-K Amendment generally require that: (i) each member of an issuer's compensation committee to be an "independent" member of the board of directors, (ii) the compensation committee may only retain compensation consultants, legal counsel, or other advisers after considering factors related to the "independence" of the adviser, (iii) the compensation committee has the authority to retain compensation consultants, legal counsel, or other advisers, (iv) each issuer must provide adequate funding to the compensation committee to retain advisers, and (v) disclosures must be made at annual shareholder meetings regarding the use of compensation consultants.

Under the Act, the SEC is required to issue its rules by July 16, 2011. Proposed Rule 10C-1 primarily serves as a set of guidelines to be used by the Securities Exchanges to develop their own rules. Each Securities Exchange would be required to submit its proposed rules to the SEC within 90 days following the

publication of the SEC's final rule in the Federal Register. The SEC would then review and approve the proposed rules developed by each Securities Exchange, to ensure consistency with the SEC's guidelines, before they become final. The SEC otherwise requires that each Securities Exchange fully comply with the SEC's rules no later than one year after the SEC's final rules are published in the Federal Register.

The SEC is currently seeking comment on each of the proposed rules. The comment period ends April 29, 2011. Instructions for providing comments are on the SEC's website at [www.sec.gov/rules/proposed.shtml](http://www.sec.gov/rules/proposed.shtml).

**Observation:** *There are currently fifteen Securities Exchanges in the United States. Because each Securities Exchange is authorized to separately establish its listing requirements to implement these principles, it is expected that these rules may vary from exchange-to-exchange. Accordingly, issuers and advisers should become familiar with the separate rules of each Securities Exchange regarding which issuers are covered, how the term "independent" is defined for this purpose, and the scope and complexity of the additional, related rules and guidelines.*

### Section 10C Listing Requirements Apply to "Compensation Committees"

The Act requires board committees that set compensation policy to consist of only directors who are independent. While neither the Act nor the Exchange Act require an issuer to establish a compensation committee, current securities exchange standards generally require listed issuers to have a compensation committee or to have independent directors determine executive compensation matters.

Although Section 10C of the Exchange Act and Proposed Rule 10C-1 applies to "compensation committees," the term "compensation committee" is not defined. Proposed Rule 10C-1 would direct the Securities Exchanges to apply its listing requirements to any committee of the board that is designated as the compensation committee or any other committee that oversees executive compensation, whether or not the committee performs multiple functions. However, Proposed Rule 10C-1 does not apply the listing standards to an issuer whose independent directors oversee executive compensation in lieu of a board committee because Section 10C refers only to compensation committees.

**Observation:** *The SEC has provided a "functionality" definition of compensation committee for purposes of the compensation committee listing rules. The SEC believes that this is appropriate to capture board committees that perform these functions and to avoid the possibility that a listed issuer might circumvent the requirements by assigning a different name to a committee that is the functional equivalent to a compensation committee.*

### Compensation Committee Independence

Proposed Rule 10C-1 requires each member of the compensation committee be a member of the issuer's board of directors, and "independent".

The term "independent" is not defined by Section 10C of the Exchange Act nor is it defined in Proposed Rule 10C-1. Both leave the definition to the Securities Exchanges after taking into consideration relevant factors. Under Proposed Rule 10C-1, relevant factors include but are not limited to:

- The source of compensation of a member of the board of directors of an issuer, including any consulting, advisory, or other compensatory fee paid by the issuer to such member of the board of directors; and
- Whether the member of the board of directors of an issuer is affiliated with the issuer, a subsidiary of the issuer, or an affiliate of a subsidiary of the issuer.

**Observation:** *The Securities Exchanges have independence standards for directors of listed issuers of securities that generally require a majority of the directors of a listed issuer to be "independent" under the exchange's listing standards, which typically include bright line independence tests. The exchanges generally also require members of the compensation committee to be "independent" under the general independence standards applicable to directors. Under the new listing requirements for compensation committees, members must be independent under the definition developed by the applicable exchange after considering the factors in the SEC's proposed rule. This definition may or may not differ from an exchange's general independence listing standards.*

*The independence standards for compensation committee members are similar to the independence standards for audit committee members under Sarbanes-Oxley, with one significant difference. The Securities Exchanges must only consider the listed factors in developing its listing independence standards*

for compensation committee members while audit committee members have specific exclusions such as not being able to accept any consulting, advisory, or other compensatory fee from the issuer other than in the capacity of a member of the audit committee.

While the rules to be adopted by the Securities Exchanges may be more restrictive than today's standards, many compensation committees have historically complied with the independence requirements under Internal Revenue Code Section 162(m). Independence rules under Section 162(m), which imposes a \$1 million deduction limitation on compensation to named executive officers, are more restrictive than most rules currently in place by the Securities Exchanges and may continue to be the most restrictive set of rules governing compensation committee member independence.

### Authority to Engage Compensation Consultants and Other Advisers

In addition to the compensation committee independence requirements, each issuer must comply with the following rules regarding the use of compensation consultants and other advisers:

- Each compensation committee must have the authority to retain and obtain the advice of compensation consultants, independent legal counsel and other advisers;
- Before selecting any compensation adviser, the compensation committee must take into consideration specific factors identified by the SEC that affect the independence of compensation advisers;
- The compensation committee must be directly responsible for the appointment, compensation and oversight of the work of any compensation adviser; and
- Each listed covered issuer must provide appropriate funding for the payment of reasonable compensation, as determined by the compensation committee, to its compensation advisers.

**Observation:** Under the Act's Rules of Construction and reiterated by the SEC's proposed rule, a compensation committee is not obligated to hire a compensation consultant or other adviser nor is it required to implement the advice of such compensation consultant or other adviser.

### Compensation Consultant Independence Factors

As previously discussed, the compensation committee may engage a compensation consultant, legal counsel or other advisers only after considering certain factors that affect the independence of the consultant or adviser. However, a compensation committee is not precluded from engaging a compensation consultant, legal counsel or other adviser who is determined by the committee to not be independent.

Section 10C(b) of the Exchange Act provides that the factors to be considered as identified by the SEC must be "competitively neutral" so as not to favor one consultant or adviser over the other by its very terms.

In considering the independence of a consultant or other adviser, the compensation committee must take into consideration the following factors, in addition to any other factors identified by the Securities Exchanges:

- The provision of other services to the issuer by the person that employs the compensation consultant, legal counsel or other adviser;
- The amount of fees received from the issuer by the person that employs the compensation consultant, legal counsel or other adviser, as a percentage of the total revenue of the person that employs the compensation consultant, legal counsel or other adviser;
- The policies and procedures of the person that employs the compensation consultant, legal counsel or other adviser that are designed to prevent conflicts of interest;
- Any business or personal relationship of the compensation consultant, legal counsel or other adviser with a member of the compensation committee; and
- Any stock of the issuer owned by the compensation consultant, legal counsel or other adviser.

**Observation:** The proposed rules do not provide any bright line test or numeric thresholds to determine independence. Rather, the determination of independence should be considered and determined by the compensation committee. Since the rules are to be competitively neutral, the SEC believes that a compensation committee may consider the "aggregate fees" received by a provider that performs multiple services to the issuer and the "concentration of fees" received by a boutique firm that provides only compensation consulting, legal or other advice to the issuer.

## Opportunity to Cure Defects in the Compensation Committee

The proposed rule requires that Securities Exchanges provide appropriate procedures allowing issuers a reasonable opportunity to cure any defects that would prohibit the listing of the issuer on the Securities Exchanges as a result of a failure to meet the requirements of Section 10C. In the event a compensation committee member ceases to be independent for reasons outside of their reasonable control, the Securities Exchanges may permit that member to remain a compensation committee member until the earlier of the next annual shareholder meeting or one year from the event which caused the member to no longer be independent.

**Observation:** *Most exchanges have adopted procedures to provide issuers with notice, a hearing, an opportunity to appeal, and an opportunity to cure defects before the issuer's securities are delisted.*

## Amended Compensation Consultant Disclosures

The S-K Amendment would require disclosure of whether the compensation committee (or another committee with equivalent functions) retained or obtained the advice of a compensation consultant. This disclosure would include a description of the nature and scope of the consultant's assignment and the instructions provided by the compensation committee. The disclosure would also include a discussion of any conflicts of interest and, if so, the nature of the conflict and how the conflict is being addressed.

If the compensation committee retains or management retains (without the compensation committee also retaining) a compensation consultant who provides additional services not limited to broad-based compensation plans or providing data developed based on parameters set by the compensation committee, and if the total amount of those additional services exceeded \$120,000, disclosure must be provided. This would include the aggregate fees for executive and director compensation services and the aggregate fees for the additional services. In addition, disclosure would be required as to whether management chose or recommended the compensation consultant and whether the compensation committee or the board approved such additional services provided by the compensation consultant.

**Observation:** *The requirements under Section 10C of the Exchange Act are similar to those currently required under existing Item 407 of Regulation S-K, and the SEC proposes to integrate these new disclosures with existing ones. Item 407 currently requires only the disclosure of the use of compensation consultants if used for advice other than for broad-based plans or advice limited to information developed at the direction of the compensation committee. Therefore, under Section 10C of the Exchange Act and the S-K Amendment, disclosure will always be required regarding the use of a compensation consultant, or lack thereof.*

## Exemptions

Every issuer of an equity security is a "covered issuer" for purposes of the compensation committee listing standards, except for five categories of issuers. An issuer of an equity security is excluded if it is:

- A controlled company;
- A limited partnership;
- A company in bankruptcy proceedings;
- An open-ended management investment company under the Investment Company Act of 1940; or
- Any foreign private issuer that provides annual disclosures to shareholders of the reasons that it does not have an independent compensation committee.

The Securities Exchanges are also authorized to exempt with respect to any covered issuer any particular "relationships" between the issuer and a member of the compensation committee from the compensation committee independence requirements, as each exchange deems appropriate. For example, an exchange could provide for a covered issuer that is owned or controlled by a private equity shareholder that a member of the private equity shareholder who is on the issuer's compensation committee is exempt from the "independence" listing requirements if the exchange deems it appropriate. In developing these exemptions, a securities exchange is to consider the size of the issuer and any other relevant factors it identifies.

## How PwC Can Help

PwC has considerable expertise in the corporate governance, financial reporting, and tax implications of the Dodd-Frank legislation. Please contact one of the individuals listed below, or your local engagement partner, to further discuss how PwC can help.

For more information on the topic discussed in this *HRS Insight* or to change your address, contact your local PricewaterhouseCoopers professional.

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